AlaskaUSA
Federal Credit Union®

May 28, 2014

Mr. Gerard Poliquin
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

Dear Mr. Poliquin:

Re: Comments on Proposed Rule: PCA - Risk-Based Capital; RIN 3133-AD77

Thank you for the opportunity to comment on the proposed rule regarding risk-base capital, as referenced above. As we have familiarized ourselves with the provisions of the rule and its implications to Alaska USA, as well as the credit union community in general, we have come to the conclusion that the stated and presumed benefits of the proposed rule are outweighed by its probable adverse unintended consequences. In fact, we have come to believe that the proposed rule is generally not in the best interest of credit unions, credit union members and, perhaps, the share insurance fund.

More specifically, and most significantly, the rule does not adequately reflect the unique nature of credit unions, vis-à-vis banks, and will place credit unions at a distinct competitive disadvantage going forward. For all but the simplest of credit unions, in the absence of material changes in activities and/or the structure of its balance sheet, the risk-based capital proposal will require additional retained earnings in order to maintain a credit union's relative capital position in terms of the buffer it has to avoid regulatory intervention in the event of adversity. Since credit unions do not have access to sources of capital to augment retained earnings, the adjustments encouraged by the proposed rule will inevitably affect adversely the competitive position and long-term growth of credit unions as they either withdraw from, or curtail, profitable activities judged by NCUA to harbor more risk than others, and/or adjust pricing to make up for the added capital requirements. This becomes particularly problematic when the risk-based capital requirements exceed those of competing community banks, which do have other potential sources of capital. With regard to this last point, with a couple of notable and wise exceptions, the proposed rule requires a greater commitment of capital, compared to the requirements for community banks, in most important asset categories likely to be prominent on the balance sheets of all but the smallest and simplest of credit unions.

We also believe that the "broad-brush" approach characteristic of the proposed rule to address NCUA's concerns regarding risks to the share insurance fund ignores important differences among credit unions, their respective fields of membership, and the markets in which they operate. Although the proposed risk-weights for the various asset categories may make sense from NCUA's "big picture" perspective, on an individual credit union basis they may not. Examples of this point applicable to Alaska USA are described below. In addition, by establishing significant risk-weight differentials among asset classes and/or to characteristics within asset classes, credit unions will have a strong motivation to evolve their activities and balance sheets to maximize their risk-based capital, regardless of their particular situation

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and whether or not the incented behaviors are in their best long-run financial and strategic interests and the service interests of their members. Accordingly, the proposed rule essentially represents a de facto assumption of important balance sheet management decisions by NCUA for purposes of protecting the share insurance fund at the expense of the current prerogatives and interests of individual credit unions and their members. Further, since the implicit incentives are the same for every credit union, over the long run, this evolution will likely cause credit unions to become less financially diverse, which will tend to increase the vulnerability of the industry and share insurance fund to some future widespread economic adversity.

One last general point, we fail to see the need to change the current capital rules. The current system, coupled with regulatory risk-management requirements, successfully coped with the most severe economic calamity since the Great Depression. Further, regulatory risk-management requirements have been enhanced since. Consequently, we believe that deficiencies in the proposed rule noted above outweigh any advantages of adopting it. Nevertheless, if the proposed rule goes forward, please consider our comments and recommendations presented below.

Credit Union Service Organizations (CUSOs):

The proposal would establish risk weights for CUSO investments at 250% of their unconsolidated book value (sum of the unconsolidated CUSOs' assets), risk weights for loans to CUSOs at 100% of the consolidated outstanding balances, and risk weights, as defined by the proposed rule, for all CUSO assets consolidated into the credit union books, pursuant to GAAP. CUSOs that are majority owned by a credit union and subject to GAAP consolidation of financial statements would be disadvantaged by this double counting of assets for purposes of calculating risk-based capital, which are first determined for the CUSO prior to consolidation, then again after the intercompany eliminations upon consolidation of the statements. In addition, since the 250% risk weighting and resulting capital requirements would be calculated on the unconsolidated book value of CUSO investments, rather than the amount of the paid-in investment, the proposed rule would, ironically, impose a disproportionately larger reserve requirement on profitable CUSOs with substantial retained earnings, compared to those that are weakly capitalized or struggling financially.

To illustrate these points, consider the impact the proposed rule would have on Alaska USA. Alaska USA operates four wholly owned CUSOs and one CUSO in which it has a controlling interest, as defined by GAAP. Over the past eight years, the credit union has averaged an 11.44% return on its investment in CUSOs. The book value of the credit union's investments in CUSOs on an unconsolidated basis, as reported in the credit union's latest year-end call report, is $66,705,538. The credit union's total cash investment in the CUSOs, as reported in the same call report, is $15,798,236. The difference between the book value of the CUSOs and the credit union's cash investment, which is about $51 million, primarily represents retained earnings of the CUSOs, since they carry few liabilities. On a consolidated basis, after inter-company eliminations pursuant to GAAP, the CUSOs accounted for $51,191,910 of the credit union's assets.

The proposed rule would require risk weighting of 250% of the $66.7 million unconsolidated assets of the CUSOs, despite the fact that over $51 million of that amount is funded by retained earnings in the CUSOs, and an additional risk weighting for the $51 million in added credit union assets after consolidating the CUSOs into the credit union's financial statements. In addition to this double counting, the proposed rule would require any goodwill recorded on the CUSOs books, pursuant to GAAP, to be deducted from the credit union's net worth. The net effect: Alaska USA's risk-based capital ratio under the proposed rule would be 12.01%, compared to 13.08% without the CUSOs. This translates to a $40.2 million capital requirement for a $15.8 million investment in highly profitable and well capitalized CUSOs with consolidated assets only one third greater than the capital requirement. In addition, this excessive capital requirement does not take into account the inherent risks, or lack of inherent risks, associated with the activities in which the CUSOs are engaged. Consequently, we believe this provision of the proposed rule is unfair and does not make sense within the context of this credit union's circumstances, and that the resulting reserve requirement is unreasonably excessive. We, therefore, recommend that the 250% risk weighting on CUSO assets before consolidation be eliminated altogether.

Investments:

Although we understand the logic and apparent motive in escalating risk weights applicable to investments with the lengthening of the weighted average life of the investments, particularly in the current interest rate environment, we believe that the proposed weighting is excessive, repressively inconsistent with competing bank requirements, and inconsistent with higher risk asset alternatives available to credit unions. Specifically, the risk weights applicable to investments for community banks are set at 20%, regardless of their maturity. However, under the propose rule, only credit union investments with a weighted average life less than one year would be assigned a weight of 20%, gradually escalating to 200% for those with a weighted average life over 10 years. This disparity could translate into a material competitive disadvantage over time, as well as potentially dysfunctional investment decisions, particularly in alternate interest rate environments that would prudently favor extended investment maturities in terms of interest rate risk, as well as yield.

In addition, the proposed weights applicable to longer term investments appear to be excessive compared to the weights associated with other credit union assets of a comparable nature. In particular, the proposed weighting for first lien mortgage loans in portfolio varies from 50% to 100%, depending on the extent of the mortgage assets within portfolio. In contrast, mortgage-backed securities would typically require a weight of 150% to 200%, despite the fact that the latter can mitigate the credit, collateral and liquidity risks inherent in booking mortgage loans. In fact, from a reserving point of view, under the proposed rule it would always be advantageous to book mortgage loans, rather than securitize them for portfolio to mitigate inherent risks, as previously mentioned. Consequently, this proposal could actually increase the risk of a credit union's balance sheet by encouraging the booking of mortgage loans in lieu of booking comparable securitized mortgage investments.

Accordingly, we recommend that the maximum weight applicable to credit union investments be established at 20%. Under the proposed rule, the additional reserving requirement for Alaska USA investments vis-à-vis community banks would be an additional $23.9 million, which represents a material competitive disadvantage.

Goodwill:

The proposed rule would deduct goodwill from the credit union's net worth in determining risk-based capital. This will serve as a major disincentive to acquiring any entity with insufficient tangible assets to justify its asking price, such as a weak or failing credit union. Accordingly, this provision may have significant unintended consequences to the share insurance fund when NCUA is trying to find a merger partner for a troubled credit union. In addition, the value of many businesses, such as insurance agencies and mortgage companies, is based on intangibles that are prudently accounted for under current GAAP rules. Deduction of goodwill in determining risk-based capital will undoubtedly affect such acquisition decisions, perhaps to the financial detriment of the credit union and/or the share insurance fund. Accordingly, we recommend that goodwill not be deducted from net worth in determining risk-based capital. In the event that the proposed rule is adopted as currently written, Alaska USA would require an additional $20.2 million in capital to cover the perceived risk of this intangible asset.

Mortgage Loan Servicing Assets:

The proposed risk weight for mortgage servicing rights (MSRs) is 250%. Although we understand and are sensitive to the operational and interest rate risks associated with MSRs, we believe that a flat 250% for all MSRs does not fairly address the potentially wide variations of risk that could exist in differing circumstances. Consequently, in many situations the weight would be punitively excessive. In addition, we believe the proposed weight is inconsistent with weights assigned to related assets with greater risk and repressively inconsistent with competing bank requirements.

More specifically, since much of the risk associated with holding MSRs relates to their volatility of value with changes in interest rates, and potential for disruption of cash flows in a falling interest rate environment, credit unions that book MSRs at or close to their current market value are at greater risk of loss in a falling interest rate scenario. Those that book MSRs more conservatively have a cushion to absorb such downward fluctuations and are in a better position to recapture their investment over a shorter period of time. In a rising rate environment, the value of MSRs and this cushion grow and the risk of loss declines. Consequently, a flat 250% in all circumstances would be punitively excessive for those that conservatively book MSRs, particularly in a low interest rate environment. This could adversely affect decisions regarding the sale of MSRs, potentially to the financial detriment of the credit union and service interests of members, as well as decisions related to the potential sale of originated mortgages into the secondary market to free capital for additional lending and to otherwise reduce risks implicit in holding mortgage related assets. It is also important to note that the operations risks of MSRs are not avoided by booking originated mortgage loans, yet the risk weight of booking such loans varies from 50% to 100%, despite the fact that such assets are burdened with a multitude of other risks not inherent in MSRs. Finally, the proposed risk weight for MSRs is in excess of the weighting applicable to community banks, which varies from 100% to 250%, depending upon the extent of holdings as a percent of capital. Such a disparity represents a competitive disadvantage to credit unions, particularly given their limited options for improving net worth.

Case in point, for or a variety of sound asset/liability and liquidity management purposes, Alaska USA sells nearly all of its mortgage loan production (approximately $1.4 billion in 2013) into the secondary market and retains a good portion of the servicing rights for member service and risk mitigation purposes, the latter in terms of the stability of earnings from the aggregate of mortgage related activities over time. The MSRs are booked at the low end of their then current market value, depending on market conditions. The credit union's MSR portfolio of $4.7 billion has a book value of $32.2 million and a current market value, determined independently each quarter, of approximately $15.4 million in excess of the book value, a sizable off-balance sheet asset. Nevertheless, the proposed rule would impose an added risk-based capital burden of $5.8 million on this credit union, compared to the banking requirement. Accordingly, we recommend that the risk weight for MSRs not exceed those applicable to community banks and, ideally, vary from 100% to 250% based on a reasonable formula related to the ratio of book value to market value.

Non-Delinquent Mortgage Loans:

The proposed risk weighting for first lien mortgage loans in portfolio varies from 50% to 100%, depending on the extent of these mortgage assets within portfolio, and from 100% to 150% for junior lien mortgage loans in portfolio, again depending on the extent of those mortgage assets in portfolio. In contrast, the comparable risk weights for community banks are a flat 50% and 100%, respectively, for first and junior lien mortgage loans. Although we understand the reasoning associated with the proposed risk weights applicable to mortgage loans, given their relative longer-term duration and exposure to interest rate risk, this provision again ignores the particular circumstances of individual credit unions. It is not difficult to image a credit union with a highly mobile field of membership and a mortgage loan portfolio with a short average life that would be discouraged from booking otherwise highly desirable mortgage loans because of the repressive capital requirements that escalate as concentrations increase. Consequently, application of this provision could very well be disadvantageous to both the credit union and its members, and the interests of the share insurance fund. In addition, it is worth noting that the lower requirement for banks represents a meaningful competitive disadvantage for all credit unions, as well as to those credit unions where application of this provision is not justifiable.

Member Business Loans:

The proposed risk weighting for member business loans varies from 100% to 200%, depending on the extent of these assets in portfolio. In contrast, the comparable risk weight for community banks is a flat 100%. In light of this and the fact that there are already limits on the amount of member business loans that a credit union can book, we believe that the higher weights applicable to member business loans when concentrations exceed 15% of portfolio are excessive and repressively uncompetitive.

ALLL limited to 1.25% of risk assets:

This section limits the amount of capital set aside for loan and related losses that can be considered in the risk-based capital calculation. We fail to see the reasoning for this limitation, since the entire balance of the Allowance for Loan and Lease Losses is available to cover losses and has already decreased the capital of the credit union when it was expensed through the credit union's income statement. Further, the propriety of the related calculations and resulting allowance are governed by GAAP and validated by the credit union's independent auditors on an annual basis. Finally, the stated objectives of this provision provided in NCUA's commentary can be easily achieved through alternate regulatory rules.

Individual Minimum Capital Requirement:

This section provides the NCUA with the flexibility to require risk-based capital for an individual credit union in excess of the requirements otherwise provided by the rule in any case where they determine that such a requirement is justified by circumstances peculiar to the credit union. We are adamantly opposed to this provision due to its subjective nature and potential for inconsistent and unfair application. Accordingly, we recommend that it be eliminated altogether.

Demonstration of Comprehensive Understanding of Asset-Backed Security:

This section provides for assignment of a 1,250% risk weight to asset-backed investments in portfolio if NCUA determines that the credit union has not demonstrated a comprehensive understanding of the features of such investments. A credit union's understanding of an investment does not have any effect on the underlying risk of the investment. The risk weighting is obviously punitive in nature and is not justifiable from a safety and soundness standpoint. Given the significance of the weighting, we are adamantly opposed to this rule due to its subjective nature and potential for inconsistent and unfair application. Accordingly, we recommend that it be eliminated altogether.

Implementation Period:

The proposed rule has an implementation period of 18 months, which is insufficient given the significance of the impact of the proposed requirements and the length of time it will take credit unions to adjust their business strategies, portfolios and capital to their best advantage relative to the rule. This task is particularly burdensome for credit unions, given their limited options for raising capital compared to banks, which were afforded a full seven years to fully implement BASEL III. Accordingly, we recommend an implementation period of at least seven years.

Summary:

For an organization that can only earn its capital, externally imposed requirements for reserves in excess of prudent levels required within the context of the organization's particular circumstances represents a material threat to the organization, in and of itself. For the reasons presented above, we view NCUA's approach to addressing concerns regarding risks to the share insurance fund as a material threat to member service and to this credit union's competitive posture and long-term health and prosperity, as well the competitive posture, diversity and long-term health and prosperity of the credit union community at large. We, therefore, recommend that the proposed rule be abandoned. Short of that, we recommend that the risk weights and resulting reserve requirements at least be modified to minimize their repressive influence on the competitive posture of credit unions in the financial services industry.

Thank you for considering our comments and position on this matter.

Sincerely,

William B. Eckhardt
President